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Recommended Citation

Susan E. Carroll, Comment, Caught Between a Rock and a Soft Place: Regulating Legal Ethics to Police Corporate Governance in the United States and Hong Kong, 14 Pac. Rim L & Pol'y J. 35 (2005).

Available at: https://digitalcommons.law.uw.edu/wilj/vol14/iss1/3

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CAUGHT BETWEEN A ROCK AND A SOFT PLACE: REGULATING LEGAL ETHICS TO POLICE CORPORATE GOVERNANCE IN THE UNITED STATES AND HONG KONG

Susan E. Carroll

Abstract: Both the United States and Hong Kong have suffered through corporate governance scandals in recent years. The two nations have tried different methods of regulating legal ethics in order to curtail future corporate governance scandals. The United States, via the Sarbanes-Oxley Act of 2002, empowered the Securities and Exchange Commission ("SEC") to dictate disclosure requirements to U.S. lawyers who represent listed corporations. This mandate creates conflicts between lawyers' duty to keep clients' secrets and their duty to disclose client information for the protection of public interests. Hong Kong took a completely different approach. The Hong Kong Stock Exchange negotiated the Memorandum of Understanding with the Hong Kong Law Society, which clarifies the scope of a solicitor's duties when practicing before the Stock Exchange. This Comment compares the United States and Hong Kong systems of regulating lawyers, specifically considering issues relating to corporate governance. It concludes that the SEC should adopt Hong Kong's style of negotiation and clarification and Hong Kong should adopt the U.S. enforcement stance and definition of the client in order to more effectively prevent corporate scandals before they start.

I. INTRODUCTION

Both the United States and Hong Kong have had serious, market-crippling corporate governance scandals in the last few years. In the United States, Enron's collapse involved a $700 million loss of net earnings, $1.2 billion loss of shareholder equity, and the discovery of more than $4 billion in hidden liabilities. In WorldCom's downfall, 7,500 people lost their jobs and investors are eventually expected to lose over $175 billion after the...
bankruptcy and bond issues are finally adjudicated. 5 While Hong Kong has not suffered similar cataclysmic collapses, Hong Kong markets and investors consistently suffer through corporate malfeasance such as BOTO 6 and, comparable to Enron and WorldCom, smaller corporate collapses such as Akai Holdings. 7 These scandals were particularly harmful to Hong Kong markets because forty percent of its 6.8 million residents are retail investors who suffered significant losses when these companies lost value. 8

In their efforts to stave off future corporate governance scandals, both the United States and Hong Kong have focused in part on the role of lawyers, or solicitors, as they are known in Hong Kong. 9 The regulation of lawyers presents a novel avenue for policing corporate governance. Lawyers are involved in virtually every fraudulent transaction, yet due to the duty to preserve a client's confidences, 1 lawyers' actions have not previously been questioned.

In 2002, just three weeks after WorldCom declared bankruptcy, 11 the U.S. Congress passed a package of major corporate governance reforms, commonly known as the Sarbanes-Oxley Act. 12 Among other changes, the Sarbanes-Oxley Act directed the SEC to regulate the lawyers representing regulated corporations. 13 This led to a rule allowing attorneys to withdraw

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6 See, e.g., Governance Offers Poor View, S. CHINA MORNING POST, Sept. 4, 2002, at 12. BOTO sold off its most profitable division at a loss to a private company owned by the CEO and used the money to purchase a failing company from another board member. Samuel Yeung, Boto Failed to Disclose Connected Transactions, S. CHINA MORNING POST, July 19, 2002, at 2.
7 See, e.g., Matthew Miller, Mark L. Clifford & Susan Zegel, Dishonored Dealmaker, BUS. WK. ONLINE, Aug. 5, 2002 [hereinafter Dishonored Dealmaker]; Justice Denied in Hong Kong (Akai Holdings Ltd.), BUS. WK., Aug. 5, 2002, at 80. The Akai founder liquidated the corporation's assets and disappeared, probably to mainland China. Id.
8 Joel Baglole, Lowering the Bar: Hong Kong Has Missed an Opportunity to Raise its Market-Regulatory Standards to Meet Global Best Practice; While Investment Banks, Brokers and Companies Might Benefit in the Short Run as a Result, Both Investors and the City's Reputation Could Suffer Irreparable Damage, FAR E. ECON. REV., Apr. 15, 2004, at 38.
9 PETER WESLEY-SMITH, AN INTRODUCTION TO THE HONG KONG LEGAL SYSTEM 91, 93 (1987). Hong Kong also has barristers, who are professional litigators. Id. This Comment focuses only on solicitors, who do the majority of work on corporate governance issues in Hong Kong, though barristers representing corporations in litigation will have similar ethics issues.
10 For U.S. lawyers, see MODEL RULES OF PROF'L CONDUCT R. 1.6; for Hong Kong Solicitors, see GUIDE FOR PROF'L CONDUCT ch. 8.
from representation and reveal client confidences, a so-called "noisy withdrawal," if the client is engaging in a qualifying fraud.14

Hong Kong started well in advance of the United States in regulating solicitors' actions in the corporate arena. In 1996, the Law Society of Hong Kong and the Hong Kong Stock Exchange negotiated a Memorandum of Understanding ("MOU").15 The MOU defines the expectations the Stock Exchange has for a Hong Kong solicitor representing a listed corporation and clearly defines a solicitor's duties when representing a listed company.16 Hong Kong was also struck by recent corporate scandals and, like the United States, is working on new regulations to control corporate governance scandals. On January 20, 2004,17 Hong Kong's Standing Committee on Company Law Reform released Phase II of its report on changes needed to Hong Kong laws to solve its corporate governance issues.18

In both countries, these new regulations are having unintended consequences. In the United States, three major problems have resulted. The first problem is that lawyers are now allowed to reveal previously protected client confidences.19 Second, since state bar associations license lawyers to practice, some lawyers are trapped because their state disclosure rules now conflict with the SEC's disclosure rules.20 Third, because states and the state supreme courts have traditionally regulated lawyers, the new federal regulations evoke federalism and preemption concerns.21

Because the MOU envisions cooperation between the regulating entities, Hong Kong would seem to have started off in a better position than the United States. Hong Kong, however, faces four serious issues. First, the

16 Id.
20 For examples, see discussion infra Part II.C.4.
21 There are also issues with the separation of powers, as the SEC is part of the federal executive branch while the state bar associations are parts of the state judicial branches and answer to the state supreme courts. However, these issues are outside the scope of this Comment.
MOU has never been used to discipline a solicitor, even though the recent scandals should have produced numerous opportunities to do so. Second, Hong Kong investors have far fewer protections than U.S. investors. Like most Asian markets and unlike most U.S. corporations, Hong Kong companies are typically family-owned or closely-held, which creates a treacherous investment environment for minority shareholders. Thirdly, the Hong Kong Securities and Futures Commission ("SFC") does not investigate and pursue violating companies in the same way as the SEC. The SFC reviews company documents before they are released, which changes the character of the SFC from enforcement to auditing. Finally, unlike U.S. lawyers, who have the Model Rule of Professional Conduct 1.13 to define their duties to corporate clients, Hong Kong solicitors who represent corporations have no such rule defining their duties. The professional rules of the Hong Kong Law Society do not clearly differentiate who the client is and to whom the solicitor owes the duty of confidentiality.

Both the United States and Hong Kong should learn from each other's regulatory activities. Each country has tried distinctly different approaches to policing corporate governance by regulating legal professionals. In the United States, improving cooperation between regulating entities and clarifying lawyers' obligations under both federal and state rules similar to what Hong Kong has done with the MOU could strengthen the SEC regulations. Hong Kong would be aided by a change in the tenor and timing of enforcement of existing regulations, as well as by a clear definition of the client for solicitors representing corporations.

This Comment examines and compares the two different methods of regulating lawyers in order to prevent corporate governance scandals. Part II discusses the corporate governance problems facing the two markets and

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24 Id. at 71.
28 See infra Part III.C.2.
29 Id.
how regulating lawyers could have prevented or mitigated past scandals. Part III reviews the passage of the Sarbanes-Oxley Act, the legal profession’s reaction to Sarbanes-Oxley, and the effectiveness of Sarbanes-Oxley regulation of lawyers. Part IV examines Hong Kong’s negotiated system of regulating lawyers and the creation of the MOU, as well as the MOU’s effectiveness in light of Hong Kong corporate governance issues. Part V compares the two systems, demonstrating how each system would benefit from the other’s methods. Finally this Comment concludes by extrapolating the potential results of these proposed policy changes.

II. THE UNITED STATES ATTEMPTS TO CURE CORPORATE GOVERNANCE ISSUES BY REGULATING LAWYERS

Following the collapse of major U.S. corporations, the corporate governance system in the United States was overhauled by the Sarbanes-Oxley Act of 2002. A key component of the Sarbanes-Oxley Act is the regulation of lawyers.\(^{30}\) Regulating lawyers is a novel and controversial step in corporate governance regulation for the United States. Legal ethics in the United States have always been the purview of the individual state bar associations and state supreme courts.\(^{31}\) It is not yet clear whether a lawyer following the rules derived by the SEC in accordance with the Sarbanes-Oxley disclosure rules will be in violation of a state’s rules of conduct for lawyers.\(^{32}\) Even though the American Bar Association (“ABA”) has adopted similar Model Rules of Professional Conduct (“Model Rules”) as the SEC, the individual states continue to debate whether the SEC rules are in conflict with or trump state rules. Regardless of the debate and the permissive nature of the rules, the recent example of TV Azteca demonstrates the possible effectiveness of the new rules.

A. The Sarbanes-Oxley Act Is Enacted to Try to Solve Corporate Governance Problems

The Sarbanes-Oxley Act did not invent the idea of using lawyers to regulate corporate governance. The ABA first approached using lawyers to address corporate governance issues when the Ethics 2000 Commission,

\(^{31}\) The notable exception is practicing before the patent bar. This exception to state’s rights was upheld in Sperry v. State of Florida, 373 U.S. 379 (1963).
\(^{32}\) See, e.g., Open Memorandum from the California Bar Association’s Business Law Section Corporations Committee, in response to the SEC’s public letter to the Washington State Bar Association (July 23, 2003) (on file with author).
chaired by Delaware Supreme Court Chief Justice E. Norman Veasey, recommended rules allowing lawyers to report up the ladder and then noisily withdraw if needed. The ABA House of Delegates rejected this recommendation in August 2001. During the Congressional debates in July 2002 on the Sarbanes-Oxley Act, Senator John Edwards commented:

This amendment is about making sure... lawyers... don’t violate the law and... ensure that the law is being followed. Unfortunately, the actions of some attorneys have drawn increasing scrutiny and criticism in light of recent events demonstrating that at least some lawyers have forgotten their responsibility.

Senator Edwards added an amendment to regulate lawyers, ordering the SEC to draft rules that allow lawyers to report up the ladder. The Sarbanes-Oxley Act worked its way through Congress during the inquiries following the Enron collapse, but stalled until WorldCom declared bankruptcy. It was passed three weeks later and became effective as of August 2002.

33 Chief Justice Veasey heads the Supreme Court of Delaware, which is the U.S. state most associated with corporate laws. For more on Delaware’s primacy on corporate laws, see, e.g., Albert Crenshaw, *Delaware Inc.*, WASH. POST, May 7, 2000, at H1; Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 STAN. L. REV. 679 (2002).

34 “Up the ladder” is a process where a lawyer or law firm, after discovering credible evidence of a material violation, reports the violation first to the corporation’s managers, then to the executives, and finally to the board of directors. For an excellent explanation of the process, see Karl A. Groskaufmanis, Climbing “Up the Ladder”: Corporate Counsel and the SEC’s Reporting Requirement for Lawyers, 89 CORNELL L. REV. 511, 518-19 (Jan. 2004) [hereinafter Climbing Up the Ladder].

35 “Noisy withdrawal” is a process whereby a lawyer or law firm, after exhausting the remedies available by reporting up the ladder, withdraws from representing the corporation, notifies the SEC of their withdrawal, and disaffirms any previous SEC filings made for that corporation that the lawyer or law firm believes to be materially false or misleading. Id. at 519-520.


42 Id.
The Sarbanes-Oxley Act added various internal checks-and-balances to the tracking of a listed corporation's finances. These included substantial additions to the duty of care for the Chief Executive Officer ("CEO"), Chief Financial Officer ("CFO"), and other Senior Finance Officers, as well as requiring CEOs and CFOs to personally sign-off on public financial statements and enacting individual penalties when these financial reports are amended. It also included requirements for outside auditing committees and extensive changes to accounting standards and accountability.

For the first time, however, Sarbanes-Oxley combined securities regulation and corporate governance requirements with the regulation of a lawyer's ethical duties. Sarbanes-Oxley section 307 ordered the SEC to begin regulating lawyers by promulgating a new rule:

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

If a lawyer finds an irregularity, the lawyer can notify the corporation's officers up the chain of command as high as the chief executive officer or the board of directors. These types of inter-organizational notifications are not considered a breach of the attorney-client confidentiality or a conflict of interest because the organization is the client, not the wrong-doing officer or

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46 Id.
49 Id. §§ 7213, 7218.
50 Id. § 7245.
51 Id.
board member. If the chief corporate officers and non-independent board members do not respond by fixing the problem, the lawyer is then authorized to notify the newly required external audit committees.

The SEC took Sarbanes-Oxley a step farther, however, when it drafted the required rule. If the issue is not sufficiently resolved internally, and if the fraudulent actions will cause significant financial or property harm to a third party, and the lawyer’s services were used in perpetrating the fraud, then, and only then, the lawyer may instigate a noisy withdrawal. In a noisy withdrawal the lawyer or law firm announces to the board that they are no longer representing the firm, notify the SEC of this action within one day, and, finally, disaffirm any SEC filings that the law firm now believes are suspect, effectively revealing the client’s confidences.

B. The American Bar Association Opt for Unity with the SEC in the Revised Model Rules of Professional Conduct

U.S. lawyers are licensed to practice in each individual state, not in the nation as a whole. Each state has its own bar association that maintains its own rules regulating lawyer conduct. The ABA is a national organization in which lawyers participate voluntarily. The ABA does not actually regulate lawyers, but influences the growth and standards of the legal profession in the United States. The ABA first drafted a Model Code of Professional Conduct as a suggestion to the state bar associations as to what their state codes should be. The ABA replaced the Model Code of Professional Conduct with the Model Rules of Professional Conduct (“Model Rules”) in 1983. The Model Rules, like the Model Code of Professional Conduct, were not binding on any lawyer in any state. Many state bar associations also switched from the Model Code of Professional Conduct with the Model Rules of Professional Conduct.

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52 Id.
53 Id.
55 Id.
56 “The ABA is a voluntary national professional association with no legal authority to adjudicate or intervene in lawyer licensing or disciplinary matters. To file a complaint against a lawyer, contact the appropriate state agency for assistance.” AMERICAN BAR ASSOCIATION CENTER FOR PROFESSIONAL RESPONSIBILITY, INFORMATION FOR THE PUBLIC, available at http://www.abanet.org/cpr/public_info.html (last visited Jan. 14, 2005).
57 Id.
Conduct to the Model Rules. Some did not switch and still operate under their version of the Model Code of Professional Conduct.\textsuperscript{60}

The Model Rules were extensively revised in 2000 by the ABA’s Commission on the Evaluation of the Rules of Professional Conduct (“Ethics 2000”).\textsuperscript{61} Delaware Supreme Court Chief Justice E. Norman Veasey chaired the Ethics 2000 Commission, which is significant because the State of Delaware is renowned for its corporate laws.\textsuperscript{62} The Ethics 2000 Commission proposal contained, among many other changes, revisions to two key rules: Model Rule 1.6 (Confidentiality)\textsuperscript{63} and Model Rule 1.13 (Organization as a Client).\textsuperscript{64} The proposed changes were very similar to the language eventually used in Sarbanes-Oxley and in the resulting SEC regulations. The ABA House of Delegates initially rejected the Ethics 2000 recommendations on Model Rules 1.6 and 1.13,\textsuperscript{65} but after the passage of Sarbanes-Oxley and the implementation of the SEC regulations in 2002, the ABA House of Delegates and membership adopted the Ethics 2000 Commission’s recommendation on August 6, 2003.\textsuperscript{66}

The state bar associations, triggered by the Ethics 2000 Commission’s revision of the Model Rules, are currently in different stages of reviewing their own Rules of Professional Conduct.\textsuperscript{67} While there is a strong push for national uniformity, federalism concerns continue to block standardization of state legal ethics.\textsuperscript{68}
1. **Model Rule 1.6 (Confidentiality)**

Model Rule 1.6 (Confidentiality) governs lawyers whether the client is an individual or a corporation. For either type of client, a lawyer may only divulge client confidences in defined exceptional circumstances. All these exceptions are permissive, including when the lawyer is acting to prevent reasonably certain death or substantial bodily harm.69

The key provisions for corporate governance are Model Rule 1.6(b)(2), (3), and (6). Model Rule 1.6(b)(2) allows a lawyer to disclose confidences to prevent clients from using the lawyer's services in furtherance of a fraud.70 Model Rule 1.6(b)(3) allows the lawyer to disclose client confidences to rectify, mitigate, or prevent the fraud in furtherance of which the client used the lawyer's services.71 Under these two rules the lawyer can only disclose if the client abused the attorney-client relationship. If the lawyer is hired to defend against the fraud claim or if the client did not use the lawyer's services to perpetrate the fraud, according to Model Rule 1.6(a), the lawyer may not disclose the fraud.72

Finally, Model Rule 1.6(b)(6) allows "other law" to regulate a lawyer's conduct.73 This highly debated language74 allows regulations like Sarbanes-Oxley and agencies like the SEC to regulate lawyer conduct, even though this task was previously delegated only to the state bar associations.75

2. **Model Rule 1.13 (Organization as a Client)**

Model Rule 1.13 (Organization as Client) is crucial to lawyers representing corporations.76 Model Rule 1.13 specifies that the lawyer represents the organization, not its officers, employees, or other persons

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69 MODEL RULES OF PROF'L CONDUCT R. 1.6.
70 Id. R. 1.6(b)(2).
71 Id. R. 1.6(b)(3).
72 Id. R. 1.6(b)(2), (3).
73 Id. R. 1.6(b)(6).
76 Chief Justice Veasey wrote, "A proper reading of Model Rule 1.13 makes it clear that in the serious corporate fraud case the lawyer must act promptly to prevent the fraud by going up the chain of command to the board of directors if necessary. In most instances the lawyer representing the corporation who successfully goes up the Rule 1.13 chain of command and stops the malfeasance, or whose 'noisy withdrawal' permitted by Rules 1.6 and 1.13 sends up red flags for the world to see, will have avoided the need to disclose his client's confidences outside the organization." Veasey, supra note 36, at 16.
associated with the organization. If the lawyer knows that one of these individuals is acting or intends to act in a way that violates the law or a legal obligation, then the lawyer can notify other members of the corporation, including the highest members. If the highest members of the corporation do not respond in a timely or appropriate manner, then the lawyer can reveal client confidences only to the extent needed to prevent substantial injury to the corporation. If the lawyer was fired for reporting up the ladder, the lawyer may continue to represent the corporation by notifying the highest members of the corporation of the fraud committed by the underlings.

C. The Sarbanes-Oxley Act and the Revised Model Rules Cause Conflict and Confusion

Sarbanes-Oxley has left both lawyers and corporations confused. Corporations and lawyers are trying to cope with the new strict requirements for outside boards, independent auditors, and greater CEO and CFO involvement. Corporations are being driven out of the market. SEC enforcements are much harsher and harder to predict under the new rules.

Lawyers find themselves in a profoundly conflicted position. They must now choose whether to reveal client confidences and, regardless of their choice, may be disciplined because the new SEC rules and the rules of professional conduct of the state in which they practice may disagree. State bar associations are bristling as the SEC attempts to regulate lawyers and the SEC is taking a heavy-handed approach to the state bar associations.

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77 MODEL RULES OF PROF'L CONDUCT R. 1.13(a)-(b).
78 Id. R. 1.13(b).
79 Id. R. 1.13(c).
80 Id. R. 1.13(e).
84 See infra Part II.C.4.
1. Confusion for Corporations and Lawyers About Corporate Governance and the New Expenses of Being a Listed Corporation

Compliance with the rules in Sarbanes-Oxley is expensive and resource consuming for both corporations and lawyers. A recent trend among small to medium sized businesses is “going private,” or applying for delisting. This complex process often involves buying out minority shareholders at a premium, but the costs of the buyout can be much cheaper than the costs of complying with the Sarbanes-Oxley requirements.

There is also a limited number of persons willing to be independent auditors. Professionals who may qualify as independent auditors for a corporation are declining because of rising liability insurance costs or because of higher sensitivity to possible conflicts of interest. These professionals are now requiring higher compensation commensurate with the greater personal risk and responsibility. Again, this prices many smaller and mid-sized companies out of the possibility of compliance.

For lawyers, the risks of representing corporations under the new disclosure requirements have increased. Mark A. Belnick, the lawyer for Tyco Corporation, was sued by the SEC for his actions related to the corporate governance abuses at TYCO and the SEC investigation of TYCO CEO Dennis Koslowski. Belnick was acquitted by a jury, but only after a long and costly litigation. The lawyers in the TV Azteca case are not being

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87 Thompson, supra note 85.


sued by the SEC; instead they are being sued by their former client for disclosing that client's alleged misconduct to the SEC.\textsuperscript{91}

2. The SEC Heightens Corporations' and Lawyers' Fears by Taking a Strong Enforcement Stance

The SEC's enforcement stance since Sarbanes-Oxley has greatly increased the risks to both corporations and their lawyers for any kind of non-compliance. Empowered by the congressional backing implicit in the passage of such a far-reaching bill as Sarbanes-Oxley, the SEC has become much more aggressive in going after companies and much less forgiving in sanctions.\textsuperscript{92} In June 2001, just a month pre-Sarbanes-Oxley, the SEC fined Arthur Andersen a record $7 million for accounting fraud.\textsuperscript{93} Post-Sarbanes-Oxley, the SEC has imposed penalties ranging from $10 million against Xerox\textsuperscript{94} to $50 million against Vivendi,\textsuperscript{95} to $750 million against WorldCom.\textsuperscript{96} These judgments also come on top of sizeable disgorgements by both the corporations and the individual officers.\textsuperscript{97}

For lawyers, monetary and criminal penalties from SEC actions are not the only consequences. A lawyer may also be sanctioned by the state bar association, which may include disbarment. These career-limiting or career-ending sanctions would be in addition to any SEC criminal charges or financial penalties. Lawyers caught in the SEC's aggressive enforcement practices may have to choose between their freedom or their career.

3. Client Confidentiality Under Attack

Client confidentiality is the foundation of any attorney-client relationship.\textsuperscript{98} The new SEC rules and ABA Revised Model Rules are chipping away at the protection of client confidences. According to Sandra

\textsuperscript{91}See infra Part II.D (Case Study: TV Azteca).
\textsuperscript{92}Climbing Up the Ladder, supra note 34, at 522.
\textsuperscript{93}Michael Schroeder, SEC Fines Arthur Andersen in Fraud Case: Big 5 Firm to Pay $7 Million After Inquiry of Audits For Waste Management, WALL ST. J., June 20, 2001, at A3. While the SEC fines in the 1980's against Michael Milken totaling $447 million and his former employer, Drexel Burnham Lambert, for $350 million were record setters, they were also anomalies. The judgment against Arthur Andersen was not seen as a similar outlier, but as a record-setting fine. Id.
\textsuperscript{98}Model Rules of Prof'l Conduct R. 1.6, cmt. 2 (2003).
J. Harris, Director of the Pacific Regional Office of the SEC, the SEC values cooperation by the embattled corporation more than anything else in making prosecution decisions. Cooperation with the SEC affects the SEC’s charging decisions, remedies sought, and criminal charges leveled. Ms. Harris cited the HomeStore case, in which the company immediately notified the SEC of possible wrongdoing, did an independent and thorough audit, gave the audit results to the SEC, waived attorney-client privilege, fired the wrongdoers, and added new controls to prevent future similar abuses. Due to the company’s swift and extensive actions, the SEC did not prosecute the company as a whole, even though eleven individuals were criminally charged. If waiving attorney-client privilege is what the SEC means by “cooperation,” then lawyers throughout the United States should be concerned about any attack by the SEC on confidentiality. If every company were as cooperative as HomeStore, the SEC would be obsolete.

U.S. lawyers no longer know to what extent their representation of their client corporations is protected. The language “rectify, mitigate, and prevent” from the ABA Model Rules is particularly concerning as there are no guidelines as to what actions rectify, to what extent must they mitigate, or what prevention measures are required. To effectively have attorneys aid in controlling corporate governance abuses, the rules need to be clear and the duties non-conflicting. This will not happen until the SEC and the state bar associations negotiate effectively with each other.

4. Conflict of Rules between the SEC and State Bar Associations

The new rules regulating lawyers has caused controversy in the U.S. legal profession. State bar associations argue that pre-emption and federalism prevent the SEC from regulating a lawyer’s conduct. In the

99 Ms. Harris’s comments were made at a seminar entitled “A Business Lawyer’s Primer on Hot Topics in SEC Enforcement,” presented jointly by the ABA Committee on Federal Regulation of Securities and the ABA Committee on State Regulation of Securities, Apr. 1, 2004, at the ABA Business Law Section Annual Conference. This report is available for ABA members at http://www.abanet.org/buslaw/mo/preium-cl/hrgrams/spr04/17/17.pdf (last visited Jan. 14, 2005) (on file with the author).
100 Id.
102 See Harris, supra note 99.
104 MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(6).
105 Id.
Congressional debate over the amendment adding lawyer accountability to the Sarbanes-Oxley bill, Senator Michael Enzi said:

I am usually in the camp that believes that states should regulate professionals within their jurisdiction. However, in this case, the state bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced.\(^{107}\)

As a result of ABA’s Ethics 2000 Commission’s work, most state bar associations are in the process of reviewing their ethics rules and many are choosing either not to accept the revised disclosure rules or to adopt a further revised version.\(^ {108}\) The Washington State Bar Association issued an Interim Formal Ethics Opinion stating that lawyers would be held to the state bar disclosure rules and not the SEC rules, therefore prohibiting lawyers from noisily withdrawing while ensuring the protection of client confidences.\(^ {109}\) The SEC responded in an open letter stating that any lawyer practicing before the SEC would be subject to the Sarbanes-Oxley rules regardless of state bar sanctions and that federal regulations trump state bar rules.\(^ {110}\) The Corporations Committee of the Business Law Section of the California Bar Association responded to the SEC’s public letter with an open letter supporting Washington’s Interim Formal Ethics Opinion.\(^ {111}\) The Washington State Bar Association also responded, requesting a compromise with the SEC: “[the Washington State Bar Association] trust[s] that the harmonization of the SEC’s permissive disclosure rule with adherence to the Washington Rules of Professional Conduct . . . best meets our respective


goals and obligations.” The Washington State Bar Association’s Ethics 2003 Committee, which was reviewing the revised Model Rules, final recommendation on the Model Rules was not compliant with the SEC rule. This recommendation was accepted by the Washington State Bar Association’s Board of Governors and has been presented to the Washington State Supreme Court. Whether the SEC chooses to litigate against lawyers in Washington or California has yet to be seen.

5. The SEC Rule is Ineffective Because It is Not Mandatory

The permissive nature of the SEC rule and the ABA Model Rules, as demonstrated by the language of “may” in the rules instead of “must” or “will,” significantly dilutes both rules. This benefits lawyers who want to protect their clients’ secrets. Whether to take any action, be it reporting up the ladder, reporting out to an audit board, or noisily withdrawing, is up to the lawyer.

Internal clauses and disclaimers also soften the rule. First, it applies only to frauds in which the lawyer’s services were used, not frauds that the lawyer discovers in the due course of representing the company. Also, those frauds must be likely to cause significant financial or property harm to a third party. If the harm is not assured, not significant, or the harm does not affect the finances or property of a third party or the corporation itself, the lawyer may not disclose.

Finally, the noisy withdrawal process is diluted as well. The lawyer or law firm only moves on to the next level if they fail to get an “adequate response.” “Adequate response” is never defined; it is discretionary to the lawyer. If informing the directors and officers does not resolve the problem, the lawyer’s next recourse is to present the issue to the independent auditors. While the auditors are independent, they have been chosen by

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115 MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(2), (3).
116 Id.
117 Id.
118 Id.
120 Id.
the board and the same officers who did not adequately respond to the lawyer's concerns. It is only after these onerous and time-consuming steps that the lawyer may finally disclose confidences to the authorities, but again only to the extent necessary to prevent the fraud. Most lawyers will find a way to silently withdraw well before this point.

D. Case Study: TV Azteca

Despite these problems, lawyers have been able to use noisy withdrawals to expose and reduce corporate fraud, such as in the TV Azteca case. On December 24, 2003, one of the first noisy withdrawal cases splashed across the business pages of the New York Times. On December 12, 2003, the firm of Akin Gump Strauss Hauer & Feld informed the TV Azteca board of directors and federal regulators by letter that the firm was withdrawing as counsel from a bond offering due to possible violations of U.S. securities laws. In the five weeks following the noisy withdrawal, reporters discovered that unconventional loans were made to TV Azteca's CEO and the CEO had a financial interest in a transaction with a cell phone service provider. These discoveries have led to a shareholder class action lawsuit. Since the withdrawal, TV Azteca stock has plummeted.

For the lawyers, this was a very risky choice. TV Azteca has retained counsel to sue Akin Gump Strauss Hauer & Feld for breaching client confidences. In addition, it remains to be seen whether the firm or its lawyers will be subject to disciplinary action by the New York State Bar Association. In this case, due to the rules of the New York Bar Association, it is unlikely that Akin Gump Strauss Hauer & Feld will be sanctioned.

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123 Id.
128 N.Y. Code of Prof'l Resp. (NY CPR) § 4-101(C) (2002). The "other law" language of NY CPR 4-101(C)(2) should allow the SEC rules derived from the Sarbanes-Oxley Act to override confidentiality.
When states' disclosure rules conflict with the new SEC disclosure rules, lawyers are caught in a no man's land between disbarment and federal charges. This is a particularly threatening place to be due to the SEC's aggressive enforcement stance. The SEC's hardball tactics with state bar associations only exacerbates this conflict. U.S. lawyers need the state bar associations and the SEC to cooperate and clarify the exact duties they owe to their clients. The SEC and the state bar associations can look to Hong Kong for an example of such cooperation.

III. HONG KONG ATTEMPTS TO CURE CORPORATE GOVERNANCE ISSUES THROUGH THE MEMORANDUM OF UNDERSTANDING AND THE STANDING COMMITTEE ON COMPANY LAW REFORMS REPORTS

Hong Kong recognized years ago that solicitors are uniquely situated in cases of corporate fraud and acted upon this belief long before the United States. The MOU between the Law Society and the Hong Kong Stock Exchange is not only an excellent example of two regulatory powers working together for mutual benefit, but it also provides clear guidance as to a solicitor's duties when practicing before the stock exchange.

Even with the MOU, Hong Kong still suffered recent corporate scandals. Similar to the Sarbanes-Oxley Act, Hong Kong's Standing Committee on Company Law Reform ("SCCLR") was tasked with proposing new regulations to improve corporate governance in Hong Kong. The SCCLR released Phase I of its report and proposed regulations in July 2001. Phase II was released in January 2004.

Unfortunately, both of Hong Kong's attempted reforms are falling short. The MOU has never been used in a disciplinary case. The Law

The NY CPR was last updated post-Sarbanes-Oxley effective Jan. 1, 2002. Id. Therefore it is likely that the NY Bar anticipated lawyers complying with Sarbanes-Oxley when the NY CPR was last updated and will likely not pursue disciplinary action against these lawyers. Regardless of the change to the NY CPR, the N.Y. State Bar Association's Business Law Section wrote an open letter to the SEC speaking against noisy withdrawal, saying that silent withdrawal should be sufficient. Letter from N.Y. State Bar Ass'n Bus. L. Sec., to the SEC (Dec. 18, 2002), available at http://www.nysba.org/Content/ContentGroups/News1/Release_attachments/businesslawcomments121802.pdf (last visited Jan. 14, 2005). The N.Y. State Bar Association Corporate Counsel Section wrote a supporting letter. Letter from N.Y. State Bar Ass'n Corp. Couns. Sec., to the SEC (Dec. 18, 2002), available at http://www.nysba.org/Content/ContentGroups/News1/Release_attachments/reedletter121802.pdf (last visited Jan. 14, 2005).

The MOU was effective in 1996. See MOU, supra note 15. Id.

See, e.g., Governance Offers Poor View, supra note 6; Dishonored Dealmaker, supra note 7.

See PHASE I, supra note 18.

See SCCLR, supra note 17.

See From the Council Table I, supra note 22.
Society rules regulating solicitors do not clearly define who the client is when the solicitor is representing a corporation. The SCCLR Phase I changes have met with limited success and the Phase II changes, while it is too soon to measure any effect, do not go far enough.

A. The Law Society of Hong Kong and the Hong Kong Stock Exchange Negotiated the Memorandum of Understanding

Solicitors are self-regulated through the Law Society of Hong Kong ("Law Society"). Established in 1907, the Law Society is comparable to U.S. state bar associations. It is a professional society, a community-relations organization, a political lobby, and a regulatory body. The Law Society maintains the Guide to Professional Conduct ("GPC"), which is the Hong Kong counterpart to a state’s rules of professional conduct.

Unlike the United States, the Law Society and the Hong Kong Stock Exchange had the foresight to realize that solicitors would be involved in corporate securities law violations. This led them to collaborate on a Memorandum of Understanding Between the Law Society of Hong Kong and the Stock Exchange of Hong Kong in 1996. The Law Society incorporated the MOU directly into the GPC as Title 15, giving the rules in the MOU the same power as any rule regulating solicitors.

In the MOU, the Hong Kong Stock Exchange agrees not to make rules regulating, state any public findings about, impose any penalties or sanctions on, or take any other kind of disciplinary action against a solicitor unless the solicitor violates one of the following three rules:

1. If a solicitor makes an untrue representation to the Exchange: made on the instructions of his client, and purporting to be so made, and which the solicitor knows to be untrue or made with reckless disregard as to its truthfulness; or made otherwise than on instructions of a client by the solicitor.


139 See Id.


141 See MOU, supra note 15.

142 Id.
knowing it to be untrue or without having made reasonable inquiries as to its truthfulness.

(2) Where a solicitor knowingly or recklessly facilitates or participates in a breach of the Listing Rules.\(^1\)

(3) Where acting for a client in relation to a listing matter, a solicitor knowingly or unreasonably fails to advise his client in relation to relevant requirements of the Listing Rules, or incorrectly advises his client in relation to such requirements, knowing such advice to be incorrect or with reckless disregard as to its correctness.\(^2\)

All other disciplinary actions are reserved solely to the Law Society.\(^3\)

The MOU also sets a clear pecking order for the rules. If a solicitor refuses to answer questions on these three actions as part of a Hong Kong Stock Exchange investigation by claiming it violates another Law Society GPC rule, then the Stock Exchange refers the matter to the Law Society to resolve.\(^4\) There is nothing in the MOU that directs a solicitor to disclose any confidential information.\(^5\) This is important to solicitors, as it sets a clear hierarchy of rules and definition of their duties, unlike the conflicts and confusion experienced by U.S. lawyers.

B. SCCLR Phase I and Phase II Reports Propose Reforms to Hong Kong Company Law

After an intense review of Hong Kong laws, the SCCLR released its final recommendations in the Phase II Government Corporation Governance Review, which included the Committee’s recommended changes to Hong Kong’s securities regulations.\(^6\) Phase I was released three years earlier.\(^7\) Both Phase Reports cite in their terms that the reports were instigated by

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1 The MOU gives further clarification on this point in an internal note acknowledging that “‘[k]nowingly participat[ing]’ in a breach is a wide concept but see below the Exchange’s express recognition of certain examples where a solicitor will not be deemed to have acted improperly.” Id.
2 Id.
3 Id.
4 Id.
5 Id. Hong Kong solicitor’s duty of confidentiality is defined in Guide to Professional Conduct, Chapter 8: Confidentiality, available at http://www.hklawsoc.org.hk/pub_e/professionalguide/ch08/ (last visited Jan. 14, 2005).
Hong Kong's need to rein in the inequitable powers held by majority shareholders and increase minority shareholder protections.\textsuperscript{150} Phase II also recognizes the need to reduce corporate scandals.\textsuperscript{151} Both Phase Reports address similar issues and come up with many similar solutions as Sarbanes-Oxley, including greater duties for directors,\textsuperscript{152} officers,\textsuperscript{153} and auditors,\textsuperscript{154} as well as increasing the rights of shareholders in private actions,\textsuperscript{155} which are very limited in Hong Kong.\textsuperscript{156} However, neither Phase Report addresses regulating solicitors. The SCCLR report is poised to try to stop corporate fraud at the beginning by affecting a director's duties, or to catch it after the fact by regulating the accountants and auditors, but it is missing the key piece—catching fraud as it happens—which solicitors are in a unique position to do.

C. The MOU, the Guide for Professional Conduct, and the SCCLR Phase I and II Reports Need To Be More Effective

These three sets of rules have not been effective in combating corporate scandals. The MOU, for all its cooperative elegance and clarity, has never been used.\textsuperscript{157} The Law Society is in the process of renegotiating the MOU in light of changes to the Securities and Futures Ordinance, but the Law Society does not want to alter the original MOU.\textsuperscript{158} The GPC does not clearly define who the client is when the solicitor has a conflict of interest between an officer or owner of a corporation and the corporate entity itself. The SCCLR Phase I amendments have not been effective,\textsuperscript{159} and the Phase II recommendations do not go far enough to protect shareholders.

\textsuperscript{150} PHASE I REPORT, supra note 18, at iii; PHASE II REPORT, supra note 18, at iii.
\textsuperscript{151} See PHASE II REPORT, supra note 18.
\textsuperscript{152} Id. at 15-20, 70-81.
\textsuperscript{153} Id. at 32-40.
\textsuperscript{154} Id. at 40-45, 126-129.
\textsuperscript{155} Id. at 83-96. Both Phase I and II reports stated that this was one of the main impediments to having active minority shareholders, something very desirable, because through litigation the companies are kept honest. Id.; PHASE I REPORT, supra note 18, at 52-60.
\textsuperscript{156} See The Expropriation Game, supra note 23.
\textsuperscript{157} See MOU, supra note 15.
\textsuperscript{159} Paul Spink & Stephen Chan, The Hong Kong Company Director's Duty of Skill and Care, 33 H.K. L. J. 139 (2003) [hereinafter HK Director's Duty].
1. **The MOU Has Never Been Used**

Under the MOU, the Hong Kong Stock Exchange does not regulate solicitors in the same way as the SEC is now trying to regulate lawyers. The problem remains, however, that the MOU has not stopped solicitors from aiding corporations in defrauding their minority shareholders, looting the company resources, or other acts of corporate malfeasance.\(^{160}\) In the eight years of its existence, the MOU has never been used in a disciplinary proceeding.\(^{161}\) The Law Society is currently in the process of revising the MOU,\(^{162}\) especially in light of the transfer of some securities enforcement powers from the Hong Kong Stock Exchange to the Securities and Futures Commission during the 2005 calendar year.\(^{163}\)

The current MOU is an excellent example of cooperation of regulatory agencies. Unfortunately, it also further limits the Hong Kong Stock Exchange's weak enforcement powers and prevents Hong Kong from turning to a noisy withdrawal system similar to that of the SEC. The Law Society needs to undertake the major step of clearly defining the client, so that solicitors can help protect the markets from corporate governance abuses.

2. **The Professional Guidelines Do Not Define the Corporate Entity as the Client**

Hong Kong solicitors lack one of the most useful tools U.S. lawyers have to protect themselves when representing corporations: Model Rule 1.13, which defines the corporate entity as the client, not the individual officers and executives.\(^{164}\) While the GPC admonishes the solicitor to be wary of dual roles and conflicts of interest when sitting on boards of directors for corporations,\(^{165}\) the GPC has no rule about an organization as a client. This is a crucial shortcoming in the GPC. Solicitors may often have a conflict of interest between the corporation they represent and the officers or directors who secured their services. This conflict is heightened in cases where the company is family-owned or closely-held, which is true for the

\(^{160}\) See *From the Council Table I*, supra note 22.

\(^{161}\) *Id.*

\(^{162}\) *Id.*

\(^{163}\) Joel Baglole, *Risk Central: Hong Kong's Market Regulation Remains Lax*, WALL ST. J., Apr. 9, 2004, at C1 [hereinafter *Risk Central*].

\(^{164}\) *MODEL RULE OF PROF'L CONDUCT R. 1.13 (2003).*

\(^{165}\) *GUIDELINES FOR PROF'L CONDUCT §7.01 (Conflict of Interest Between Solicitor and Client) cmt.*
majority of Hong Kong companies. The lack of legal protections for minority shareholders and the growing number of retail investors in Hong Kong are also bringing this problem into sharp focus.

a. Solicitors Have a Conflict of Interest Between the Owners or Officers and the Corporation for Hong Kong's Mainly Family-Owned or Closely-Held Corporations

Like all Asian markets, Hong Kong has had ongoing problems with corporate controls and governance due to the family-owned and closely-held nature of many of its corporations. The resulting lenient internal controls led to numerous mini-Enron collapses. The lack of controls also harmed investor confidences in investing in Asia, which in turn negatively effected Asian economies and slowed down the recovery from the recession that began in 1997. U.S. institutional investors are already turning down opportunities in Asia due to the lack of corporate controls on family-owned businesses. Hong Kong is especially vulnerable to corruption because of the opening of new markets in China, the ownership and makeup of the Hong Kong Stock Exchange, and the current state of corporate governance regulations, remedies, and punishments. Solicitors in Hong Kong need a rule similar to Model Rule 1.13 to allow them to differentiate between representing the corporation and representing the controlling family members.

b. Hong Kong Has Minimal Protections for the Growing Numbers of Minority Shareholders

Hong Kong's dearth of protections for the growing number of minority shareholders compounds the problems that result from closely-held

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166 See The Expropriation Game, supra note 23.
167 See Part III.C.2.b infra.
170 Chang Q. Sun, supra note 168.
172 Id.
173 Loretta Ng & Ruby Chan, China-Related IPOs Meet Growing Demand—Record Offering for 2003 Puts Hong Kong at Center of a Boom in New Issues, ASIAN WALL ST. J., Dec. 8, 2003, at M2.
175 Risk Central, supra note 163.
and family-owned corporations cheating retail investors and creating more conflicts for solicitors. Both the Hong Kong Securities and Futures Commission ("SFC") and corporations are anxious to lure in a diverse investment base, but, once shareholders buy their stock, the minority shareholders have very limited rights.\(^{177}\)

When Hong Kong's typical family-owned corporations\(^ {178}\) need to gain additional capital, the family takes the company "public" by floating twenty-five percent of the shares on the Hong Kong Stock Exchange.\(^ {179}\) This never allows the investor shareholders to gain either a controlling interest or even enough votes to place a member on the board, let alone affect major change in relation to an expropriation, merger, or acquisition.\(^ {180}\) Investors who buy shares in non-listed companies actually fare a bit better because they can fall back on Companies Ordinance \(^{168A}\),\(^ {181}\) which allows shareholders recourse to the courts if the company's operation has been unfairly prejudicial to the minority shareholder's interests.\(^ {182}\)

Just prior to the transfer of Hong Kong sovereignty from Britain to China, the SFC implemented an interim order regulating initial public offers that effectively mandated the entry of a greater number of minority shareholders into the market.\(^ {183}\) The goals of the interim order were to limit purchases of the entire initial public offer by single individuals or entities, as well as to diversify the investment base and to slow down the rate of initial public offers.\(^ {184}\) The interim order stipulated that half of the shares of an initial public offers must be reserved for investors who are investing less than $5 million dollars.\(^ {185}\) This interim law is still in place and Hong Kong continues to have a significant and growing number of minority investors.\(^ {186}\)

While the number of minority shareholders is rising, they still lack the right to privately sue in securities cases or to instigate class action

\(^{176}\) The SEC and the SFC hold analogous positions in the U.S. and Hong Kong markets.

\(^{177}\) The Expropriation Game, supra note 23.


\(^{179}\) Companies Ordinance, § 42 (1997).

\(^{180}\) The Expropriation Game, supra note 23.

\(^{181}\) Companies Ordinance, § 168A (1997).

\(^{182}\) Id. See The Expropriation Game, supra note 23, at 87, for a discussion of what meager benefits these expanded rights include.

\(^{183}\) Erik Guyot, Hong Kong Seeks to Stem Funds Pouring Into IPOs, WALL ST. J., May 23, 1997, at A9B.

\(^{184}\) Id.

\(^{185}\) Id.

\(^{186}\) Economist Intelligence Unit—Executive Briefing, ECONOMIST INTELLIGENCE UNIT LTD. 310, Apr. 16, 2004.
One of the main protections offered to U.S. minority shareholders is the ability to initiate a lawsuit for private damages on behalf of a shareholder, as well as filing class action lawsuits for all damaged shareholders. This protection does not exist in the Hong Kong markets. The Akai Holdings bankruptcy offers a perfect example of why this distinction between investor protections is important. Hong Kong shareholders and creditors are still without recourse for the hundreds of millions of dollars that disappeared. Hong Kong creditors call the case "Hong Kong's Enron." The Singer Sewing Machine Co., a U.S. company that Akai purchased and revived, has safely emerged from bankruptcy court as a going concern. The U.S. Singer Sewing Machine bondholders have been able to file suit against Akai CEO James Ting, his former U.S. accountants, and his former U.S. bankers in an attempt to recover their losses.

Hong Kong's minority shareholders are further limited by unfair company rules, such as the rules allowing hand votes at annual shareholder meetings and by severe limitations on proxy voting. David M. Webb, retired Corporate Finance Director of BZW Asia Limited and member of the Shareholders' Sub-committee of the SCCLR, publishes a "Practitioner's Guide to Listing Rules Loopholes," which informs minority shareholders of the most popular ways in which family-owned Hong Kong corporations will try to discount their votes. A current and long-standing practice is for controlling directors to grant one or two shares to hundreds of employees and require them to attend the annual meeting. When votes come up, the sea of employee hands voting the way their bosses required them to vote overwhelms the legitimate minority shareholders' votes.

Mr. Webb also cautions against other common dishonest practices. Some boards delay reporting of company news to extend the one-month

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187 The Expropriation Game, supra note 23, at 93-97.
188 Id.
189 Securities and Futures Ordinance, § 22 (2003) (a corporate director's immunity from civil lawsuits).
190 See infra Part III.E.
191 Dishonored Dealmaker, supra note 7.
192 Id.
193 Id.
194 Hong Kong Stock Exchange, Main Listing Board Rules 13.39.
197 Id.
198 Id.
insider trading blackout to facilitate directors’ insider-trading. Another trick is to set a five-day count-back for stock options pricing. This allows directors to grant themselves options immediately after a major announcement priced at the stock value five days prior to the announcement. Designating the controlling shareholder of a company as a discretionary trust is yet another way directors get around the rules prohibiting connected persons and interested parties from being involved in any mergers or transactions. The true size of the company or the stock pool is rarely published, so minority investors may never know the true value of their holdings. Finally, as the company must only notify the SFC and not the public regarding the resignation or firing of auditors or company secretaries, the board may choose not to notify shareholders of major auditor and accountant staff changes, key indicators of ongoing corporate fraud.

c. The Incorporation of the Hong Kong Stock Exchange and the Enforcement Strategy of the Hong Kong Securities and Futures Commission Contribute to Solicitors’ Woes

The Hong Kong Stock Exchange, unlike other traditional independent exchanges, is a for-profit corporation that is listed on its own exchange. Hong Kong’s listing rules are much more flexible and less restrained than those of its U.S. and British counterparts, and Hong Kong investors do not have the ability to seek class-action recourse from the courts. Unlike the SEC, the SFC does not investigate companies after public offerings to verify the accuracy of the company’s financials. The SFC focuses on auditing and reviews the filings provided by the company before they are issued to the public. This enforcement stance does not adequately protect investors,

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199 Id.
200 Id.
201 Id.
202 So after a placing has been announced, you will not know when it is completed. If it is a 'best efforts' placing, you won't know how many shares are finally issued. When employees exercise their share options, you will not know. When shares are issued as deferred consideration under a previously announced transaction, you won't know.” David M. Webb, The Practitioner’s Guide to Listing Rules Loopholes, at http://www.webb-site.com/loopholes.htm (last visited Jan. 14, 2005).
203 Id.
205 Risk Central, supra note 163.
206 Securities and Futures Commission of Hong Kong: Whom and How We Regulate, supra note 25.
allows solicitors and companies to more easily offer inaccurate reports, and drains resources from the prosecution and investigation offices. Finally, while the SFC can publicly sanction corporations and in extreme cases delist them, it cannot instigate criminal proceedings against corporations or levy sizable fines.  

3. SCCLR Phase I Did Not Solve the Problems and Phase II Does Not Go Far Enough

The SCCLR recommendations will strengthen Hong Kong's markets, but both reports could have presented much stronger solutions. Both phases of the SCCLR reports are being used to diligently close loopholes in Hong Kong's Companies Ordinance, Main Board Listing Rules, and Securities and Futures Ordinance, including eliminating a case-law-based virtual indemnification of incompetent board members and adding much needed auditing and director controls. The reports also helped with the much-needed consolidation of the Securities and Futures Ordinance. However, neither Phase Report even mentions regulating solicitors, although solicitors are involved in every aspect of the actions regulated by the affected ordinances, listings on the main board, and major transactions.

One of the SCCLR Phase II Report's biggest victories for minority shareholders was to allow proxy voting at the Annual General meetings, though voting by a show of hands is still allowed which undercuts this victory. The other Phase II victory was extending civil rights to shareholders and the acknowledgement that Hong Kong should move toward allowing class action derivative shareholder suits, though the SCCLR does not

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208 The Expropriation Game, supra note 23.
209 Id.
211 See HK Director's Duty, supra note 159. Prior to the SCCLR Phase II Report a director was held to the standard of the director's own experience and qualifications, or "an idiot was held to the standard of being an idiot." Id. at 143. The SCCLR Phase II report increased this standard to include the skill and diligence generally associated with the position and included a recommendation for tracking corporate director training programs. PHASE II REPORT, supra note 18, §§ 3.1, 3.9.1.
212 See, generally HK Director's Duty, supra note 159.
214 PHASE II REPORT, supra note 18, §4.5.1, at xxi.
215 Id.
recommend the immediate adoption of this change. The SCCLR reports are important steps to curing the deficiencies in the Hong Kong markets for minority investors. As the SCCLR is, indeed, a standing committee, further recommendations may make the Hong Kong markets even safer.

D. Case Study: BOTO

The impact of the lack of control over family owned or closely-held corporations is highlighted by Boto, Inc. Boto sold off its successful artificial Christmas tree and patio furniture division to a company partially owned by Boto CEO Michael Kao Cheung-Chong. The price of the sale was a bargain for the purchasing company. This sale was made to fund Boto’s experimental computer graphics unit. As it turned out, the computer graphics division was acquired to personally benefit another board member. Another reason for the sale of the Christmas tree division was to move a profitable division to a non-public company that solely benefited Boto’s majority owners. Minority shareholders appealed to the SFC to investigate or stop the sale. In an unprecedented move, Andrew Sheng, Chairman of the SFC, released an open letter to investors. The letter informed the investors that the Commission would not step in to protect their investment and suggested that, if they were displeased with the way Boto was being run, they should sell their stock. After the full details of the Boto transactions came to light, Mr. Sheng retracted his earlier statement and acknowledged that some regulatory intervention into questionable transactions would have been appropriate.

216 Id. at 106.
217 See Governance Offers Poor View, supra note 6.
221 Id.
223 The Expropriation Game, supra note 23, at 80-81.
226 Yiu, supra note 224; Yeung, supra note 225.
E. Case Study: Akai Industries

Akai Holdings Ltd. demonstrates Hong Kong’s problems with internal controls on closely-held corporations and the shareholder’s lack of civil recourse. In 1982, Akai CEO James Ting started with a small electronics firm and built it into a multi-national empire by buying well-known brands that were in financial trouble and reinvigorating them. Akai Holdings revived stocks as diverse as Singer (sewing machines), Sansui (electronics), and Hang Ten (fashion). At its peak it sold $1.4 billion in merchandise per year. Akai held more than $2 billion in assets. In January 1999, the company had $262 million in cash and $1 billion in shareholder equity. In the summer of 2000, Mr. Ting transferred management control to a holding company, liquidated many personal and corporate assets without stockholder approval, and disappeared, probably into mainland China. The resulting investigation uncovered a corporation with few internal controls on spending, allowing Mr. Ting to use corporate accounts as his personal petty cash. Non-existent assets, which were used to secure hundreds of millions of dollars in debts, were shuffled and lost through various accounts in countries such as the British Virgin Islands, Liberia, and Jordan. Investors in Hong Kong are still waiting for a criminal prosecution, which will be worthless when it happens because no one can find Ting. While Hong Kong investors have no real recourse, bondholders in the United States are able to attach Akai’s U.S. assets and will probably be made whole again.

IV. The United States and Hong Kong Each Have Part of a Solution for Effective Use of Lawyers to Aid in Corporate Governance Reform

Both the U.S. and Hong Kong systems have strong and weak points, in nearly mirrored opposition. The two countries should learn from each other. The SEC should negotiate more with the state bar associations, not just to relieve the tensions and stave off the inevitable lawsuits, but to come

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228 Jane Moir, Corpse Stripped to Bones, S. CHINA MORNING POST, June 20, 2001, at 1.
229 Id.
230 Id.
231 Dishonored Dealmaker, supra note 7.
232 Id.
233 Corpse Stripped to Bones, supra note 228.
234 Id.
235 Id.
236 Id.
237 Dishonored Dealmaker, supra note 7.
238 Id.
up with a clear definition of a lawyer’s duties when representing a listed corporation. Hong Kong needs to step up the tenor and timing of its enforcement practices for both securities violations by companies and for solicitors violating the MOU. Hong Kong also needs to clearly differentiate the corporate entity as the client, so lawyers will be able to help public companies resist the tactics of majority controlling shareholders.

A. In the United States, the SEC Should Negotiate with Bar Associations and Companies to Ease Tensions and Increase Clarity of a Lawyer’s Duties

Hong Kong’s approach of negotiation and clarification would help the current situation in the United States. The SEC should be more willing to negotiate with bar associations and companies. If the SEC wants companies to cooperate, it should back down from demanding cooperation, skyrocketing penalties, and its aggressive prosecution stance. While on the one hand the SEC lauds cooperation by firms such as HomeStore, it should realize that the rising penalties and strong-arm enforcement methods will discourage companies, auditors, officers, and attorneys from cooperating in all but the most extreme criminal cases.

The ongoing battles between the state bar associations as well as the SEC’s firm take-no-prisoners stance on what is a contentious federalism issue only worsens the confusion about and resistance to the new rules. U.S. lawyers should consider the benefits of a negotiated compliance, such as the MOU. While there has not been a case under the MOU, its preeminence in the rules of conduct would put lawyers on notice of their duties both to the integrity of the market and to the ethical standards of the Law Society.

The SEC negotiating with the state bar associations would not only reduce tension, but also result in a clear definition of the lawyer’s duties to the client, the state rules, and the SEC. This clarity would allow lawyers to better represent their clients and to protect themselves from malpractice lawsuits, ethics complaints, and SEC sanctions.

The MOU may have helped in the Enron case, both to discover and curb the fraud earlier and to give the SEC another avenue to increase the victim’s fund by allowing the SEC to pursue the lawyers. Enron involved breaches of accounting standards and corporate governance controls. The

239 Another feature of Sarbanes-Oxley is that SEC penalties and disgorgements no longer go to the United States Treasury; they go to a “Fair Fund” to be used to rectify and mitigate victim’s damages. 17 CFR §§ 201.1100-1106.

lawyers may not have knowingly or recklessly participated in the violations, but discovered afterwards that their services were used in furtherance of perpetrating frauds on the market. Because the MOU does not allow for this hindsight correction, the SEC should maintain the reflective portions of the Sarbanes-Oxley-derived regulations.

B. Hong Kong Should Scale Up Enforcements and Clarify the Relationship Between the Solicitor and the Corporation

Hong Kong needs to increase the tenor and timing of enforcement of its securities regulations. For solicitors, the laws are in place and just need to be used. The threat of a noisy withdrawal is also needed to give the solicitor power in negotiating with the client. The Hong Kong Law Society should consider adopting a new GPC similar to Model Rule 1.13 (Organization as a Client). This allows lawyers to represent the listed corporation, not the majority owners.

There are three levels of enforcement involved, all of which need to be strengthened or pursued more aggressively by regulators in Hong Kong. First of all, on the client-level, the solicitor should be able to noisily withdraw. This process would give the solicitors the power to keep a company's directors and owners honest while giving early warning to investors to do their own research into the company. In the Akai bankruptcy, a lawyer responsible for moving assets would possibly have seen well in advance of the bankruptcy that the emperor had no clothes—there were no assets supporting the financing arrangements. A noisy withdrawal could have alerted the authorities before the money, and Mr. Ting, vanished.

In the TV Azteca case, the most Akin Gump Strauss Hauer & Feld would have been able to do under the GPC, even including the MOU, was silently withdraw, choosing to neither knowingly nor recklessly participate in a Hong Kong Stock Exchange violation. There is no affirmative duty to inform the Hong Kong Stock Exchange, nor a process to inform the exchange, aside from telling the truth in a tribunal. Neither the investors nor the corporation would have been protected from the fraudulent self-interested actions of the TV Azteca CEO. A less scrupulous or less thorough firm would not be prevented from completing the transaction. The regulatory agency would have no idea of the fraud taking place. The

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242 See MOU, supra note 15.
corporation’s alleged violations would continue; and the shareholders would still be damaged.

The second enforcement level needing improvement is the Law Society. It is doubtful that during the years the MOU has been in place not a single violation of its provisions has occurred, yet the MOU has never been used in a single prosecution. The Law Society needs to more aggressively pursue these violations. When solicitors see that their ability to practice is on the line, they may be more inspired to stand up to corporate officers.

The final level of enforcement improvement is at the SFC and Hong Kong Stock Exchange. These organizations should switch their focus from pre-release auditing to verifying posted corporate information. Regardless of whether the switch is made, the SFC needs to take the new recommendations of the SCCLR and actively pursue violators. As seen in the HomeStore case, fear can work. If, like HomeStore, the errant company knows that the regulatory agency will come down swiftly and severely on any infraction, then companies, as HomeStore did, will strive to remain in compliance with regulations.

The MOU also contains no differentiation between the duty to the organization as a client, as opposed to the directors and officers. Again, this is a key to protecting Hong Kong companies from their majority owners. While the MOU is an impressive and far-sighted agreement, it still does not protect minority shareholders from the tyranny of the majority owners. Hong Kong Law Society should consider adopting Model Rule 1.13 (The Organization as a Client). Adopting Model Rule 1.13 may have helped in the Boto case. A solicitor acting under a rule similar to Model Rule 1.13 may have raised red flags to the board and to the authorities about the CEO selling off the corporation’s most successful division for well below market value in order to give more funding to a non-profitable division that was purchased from another interested board member. Here, as the highest officers were involved, reporting up would have been futile, but reporting out options would still be available to the solicitor.

C. Hong Kong Should Make These Changes Slowly to Remain Competitive with Chinese Markets

Adopting similar regulations to Sarbanes-Oxley may prevent Hong Kong from continuing to open up Chinese markets and giving investors

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243 See comments by Sandra J. Harris, supra note 99.
244 Id.
access to Chinese corporations. The strict auditing and outside board member requirements may deter corporations from listing in Hong Kong, sending the new corporations to lesser-regulated markets, such as Shanghai.

Competition among East Asian markets is intense, but the East Asian market that Hong Kong should be most worried about, however, is mainland China. China and Chinese corporations are becoming savvier in the world markets, with or without the "gateway" the Chinese Central Government envisions Hong Kong providing.246 The Initial Public Offering ("IPO") for China Telecom,247 a previously government-owned utility, listed on both the Hong Kong and U.S. stock exchanges.248 China Telecom is only the first of many state-owned companies being offered,249 as investors looking to get into mainland China markets consider buying large state-run Chinese IPOs a safe option.250 These mainland Chinese corporations can access "the huge pool of domestic savings by selling renminbi-shares,"251 while companies incorporated in the Hong Kong Special Administrative Region must get permission to raise capital in mainland China.252 China maintains greater control over companies operating in the mainland than in the Hong Kong Special Administrative Region, and therefore taxes the mainland and Hong Kong corporations differently to encourage mainland investment.253 China's internal banks are preparing to sell shares of stock.254 Mainland China is also actively pursuing corporate governance reforms in order to compete in attracting international investors.255 Not only is Shanghai competing with Hong Kong to become the entryway to Chinese markets, but questionable

246 Dellapenna, supra note 171, at 93.
251 Keith Bradsher, China Announces New Bailout of Big Banks, N.Y. TIMES, Jan. 6, 2004, at c.1.
Chinese companies are already using Hong Kong’s international reputation and listing on the Hong Kong Stock Exchange, only to be sanctioned later.256

Hong Kong, therefore, needs to take slow steps toward regulation. Moving to a fully-regulated system quickly may hinder its competitiveness vis-à-vis other Asian markets, even while improving accountability to minority and international shareholders.

V. CONCLUSION

Lawyers and solicitors are in a unique position to detect and prevent corporate fraud. Both the U.S. and the Hong Kong systems appreciate this, but the two systems approach controlling lawyers and solicitors very differently. The United States strong-arms lawyers to comply with disclosure rules; Hong Kong negotiated a clear agreement between two enforcement entities. Both systems need to be strengthened in order to assure compliance, however, or both systems will continue to rely on the fallible adherence to the rules by lawyers and solicitors.

Lawyers and solicitors also must protect their client’s secrets. This is inherent to any legal practice and should be respected, if not revered. Any disclosure of information should be highly selective, both in what is disclosed and to whom it is disclosed. However, to protect third party interests, this escape valve must be allowed. When the client has abused the attorney-client privilege and used the lawyer or solicitor to commit fraud, the lawyer or solicitor should be able to protect herself and her professional reputation and withdraw from representation in a way that most benefits their true client, the corporation.

As long as officers’ and executives’ jobs are on the line, or as long as owners of public corporations control the boards, there will always be a temptation to act fraudulently. When officers, executives, and directors fail to resist the temptation, the only remaining protections for investors are the lawyers. Senator Edwards said, “The truth is that executives and accountants do not work alone. Anybody who works in corporate America knows that whenever you see corporate executives and accountants working, lawyers are virtually always there looking over their shoulder.”257 Senator Jon Corzine, a former corporate lawyer, said, “We cannot overlook the role corporate lawyers...play in addressing abuses and ensuring that our markets have integrity.”258

256 Id.
258 Id. (remarks by Senator Jon Corzine).
Focusing on lawyers is an appropriate way to prevent corporate fraud. Setting up a framework where lawyers and solicitors have a clear understanding of who their client is, what their duties to their client are, which rules of professional conduct apply, and a certainty of enforcement of these rules will strengthen any financial market. Hong Kong has half the necessary pieces. The United States has the other half. By learning from each other, they could both build effective markets of the highest integrity, which would be a safe haven for investors, corporations, and legal professionals.